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In the Supreme Court of the United States

OCTOBER TERM, 1956

No. 250

GOLDSTEIN BROTHERS, INC., PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the Tax Court (R. 28–34) is reported in 23 T. C. 1047. The opinion of the Court of Appeals is reported in 232 F. 2d 566.

JURISDICTION

The judgment of the Court of Appeals was entered on April 11, 1956. On July 9, 1956, the time for filing a petition for writ of certiorari was extended to July 25, 1956. The petition was filed on July 13, 1956. The jurisdiction of this Court is invoked under 28 U. S. C., Section 1254.

QUESTION PRESENTED

Whether the courts below erred in determining that there had been no reorganization within the meaning of Section 112 (b) (10) of the Internal Revenue Code of 1939 when taxpayer, formed by the stockholders of an insolvent corporation, purchased the assets of the corporation for cash from the trustee in bankruptcy at public sale.

STATUTES AND REGULATIONS INVOLVED

The relevant statutes are Sections 112 (a), 112 (b) (10), 112 (g) (1), 113 (a) (22), 718 (a), and 760 (a) of the Internal Revenue Code of 1939, and Section 121 (e) of the Revenue Act of 1943. These, and Section 29.112 (b) (10)–1 of Treasury Regulations 111, are set forth in the Appendix, *infra*, pages 8–14.

STATEMENT

The facts, as stipulated (R. 25–27) and as found by the Tax Court (R. 28–30) and accepted by the Court of Appeals (Op. 1–3, 5–6), may be summarized as follows:

Taxpayer was organized in February, 1934, under the name of Washington and Delaware Mercantile Company, with an authorized capital of 335 shares of preferred stock of $100 par value and 500 shares of common stock of no par value. The paid-in capital amounted to $33,500. Taxpayer was organized by the former stockholders of Goldstein Brothers, Inc., herein referred to as

the old corporation, which was organized in 1923. The common stock was issued on December 31, 1935, to the former stockholders of the old corporation in the same proportions as their holdings in that corporation. This transaction was recorded on taxpayer's books as a debit to good will and credit to capital stock in the amount of $20,500. (R. 28–29.)

On January 31, 1934, the old corporation filed a voluntary petition in bankruptcy. The total claims of general creditors were $84,474.88. (R. 29.) On February 26, 1934, the assets of the old corporation were sold to taxpayer at public auction by the trustee in bankruptcy for $48,025. (R. 29.) After the sale, which was approved by the referee in bankruptcy, there was available for the payment of creditors $44,592.02. (R. 29.) The appraised value of the property of the old corporation transferred at the sale, as reported by the trustee in bankruptcy (Stip. Ex. 7–G) and as stated by the Court of Appeals (Op. 6), was $55,671.11, including stock of goods, fixtures, and accounts. At the time of the organization of the old corporation in 1923, its net assets amounted to $434,612.49.

The trustee's report of the sale (Stip. Ex. 7–G) shows that the assets were first divided into lots and parcels and so offered for bids. The total of the bids on these several lots and parcels amounted to $30,650. Taxpayer, if it bid, was not the high

bidder on any of the lots or parcels. Then, after consulting only with his attorney and the auctioneer, the trustee decided to offer the entire assets of the old corporation. On this offering, taxpayer made a bid of $48,025, which was the highest bid and was accepted by the trustee (Op. 5–6.)

In its excess-profits tax return for 1943, 1944, and 1945, taxpayer computed its excess-profits tax credit by the invested-capital method and used as the basis of the assets acquired at public auction the basis of those assets in the hands of the old corporation ($434,612.49). The Commissioner, however, took as the basis the cost to the taxpayer at the sale ($48,025). (R. 30.) On review of the Commissioner's determination in the Tax Court, the parties stipulated that the issue is whether the bankruptcy proceedings and the sale constituted a tax-free reorganization within the meaning of Section 112 (b) (10) of the Internal Revenue Code of 1939, so as to entitle taxpayer to use the basis of the assets in the hands of the old corporation in computing its excess-profits credit. (R. 30.) The Tax Court upheld the Commissioner's determination (R. 30–34), and the Court of Appeals unanimously affirmed.

ARGUMENT

Section 112 (b) (10) of the Internal Revenue Code of 1939 (Appendix, *infra*, p. 8) is one of the exceptions to the general rule of Section 112 (a) (Appendix, *infra*, p. 8) that upon the sale or

exchange of property the entire gain or loss shall be recognized. It provides that no gain or loss shall be recognized if property of a corporation is transferred in pursuance of an order of the court having jurisdiction in a receivership, foreclosure, or similar proceeding—

> to another corporation organized or made use of to effectuate a *plan of reorganization approved by the court* in such proceeding, in *exchange solely for stock or securities* in such other corporation. [Italics supplied.]

In the instant case, as the courts below pointed out, none of the principal requirements of the statute was satisfied. There was no plan of reorganization; no plan of reorganization was approved by the court; and the consideration for the transfer was solely cash instead of stock or securities.

These findings of the courts below are clearly correct. There is no evidence of any consultation with the creditors, nor of the submission of any plan to the court. There was no exchange of stock or securities; neither the old corporation nor the creditors received any stock in the new corporation. This was liquidation, not reorganization.

Taxpayer cites no decisions of any other Court of Appeals in conflict with the decision below. On the contrary, the decision is in accord with such cases as *Mascot Store Co.* v. *Commissioner*,

120 F. 2d 153 (C. A. 6th); *Templeton's Jewelers* v. *United States*, 126 F. 2d 251 (C. A. 6th); *Wells Fargo Bank & Union Trust Co.* v. *United States*, 225 F. 2d 298 (C. A. 9th). The decision is also in accord with *D. W. Klein Co.* v. *Commissioner*, 123 F. 2d 871, and *Ketler* v. *Commissioner*, 196 F. 2d 822, both previously decided by the court below.

Taxpayer argues (Pet. 12–13, 21) that if the stockholders in the new corporation are the same as the stockholders in the old corporation there was a tax-free reorganization under the "continuity of interest" test, citing (Pet. 10–11) *Helvering* v. *Limestone Co.*, 315 U. S. 179, and *Palm Springs Corp.* v. *Commissioner*, 315 U. S. 185. In each of those cases, however, this Court was careful to point out that there had been effective compliance with the literal language of the statute. 315 U. S. at 182, 184, 188. The "continuity of interest" test, laid down in *LeTulle* v. *Scofield*, 308 U. S. 415, was applied only for the purpose of determining whether the benefits of the statute should be denied notwithstanding compliance with the literal language of the statute. In each case, it was held that the creditors who had initiated the reorganization possessed the necessary "continuity of interest" in the old and the new corporations. On the other hand, as already noted, here none of the principal requirements of the statute was satisfied. Moreover, at the time of the sale, the stockholders of the new corpora-

tion, who had also been stockholders in the old corporation, had, because of the insolvency and bankruptcy of the old corporation, no proprietary interest in its assets. Taxpayer's contention thus runs contrary to the reasoning of the *Limestone Co.* and the *Palm Springs Corp.* cases, *supra*.[1]

CONCLUSION

The decision of the court below is correct, is in accord with the applicable decisions of this Court, and is not in conflict with the decision of any other Court of Appeals. It is respectfully submitted that the petition for a writ of certiorari should be denied.

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AUGUST 1956.

[1] The other decisions cited by taxpayer (Pet. 9, 11, 12, 13, 14, 15, 16, 17, 18) are similarly distinguishable on the ground that the reorganizations there involved recognized the proprietary interest of the creditors of insolvent corporations, as well as on the grounds referred to in the opinion of the court below. More particularly, *Pebble Springs Distilling Co.* v. *Commissioner*, 231 F. 2d 288 (C. A. 7th), pending on petition for certiorari, No. 223, is distinguishable, not only because it involves a different section of the statute, as the court below noted, but also because there was no insolvency or bankruptcy and there were no intervening interests of creditors.

APPENDIX

Internal Revenue Code of 1939:

SEC. 112. RECOGNITION OF GAIN OR LOSS.

(a) *General Rule.*—Upon the sale or exchange of property the entire amount of the gain or loss, determined under section 111, shall be recognized, except as hereinafter provided in this section.

(b) *Exchanges Solely in Kind.*—

* * * * *

(10) [As added by Sec. 121 (a), Revenue Act of 1943, c. 63, 58 Stat. 21] *Gain or Loss Not Recognized on Reorganization of Corporations in Certain Receivership and Bankruptcy Proceedings.*—No gain or loss shall be recognized if property of a corporation (other than a railroad corporation, as defined in section 77m of the National Bankruptcy Act, as amended) is transferred, in a taxable year of such corporation beginnig after December 31, 1933, in pursuance of an order of the court having jurisdiction of such corporation—

(A) in a receivership, foreclosure, or similar proceeding, or

(B) in a proceeding under section 77B or Chapter X of the National Bankruptcy Act, as amended,

to another corporation organized or made use of to effectuate a plan of reorganization approved by the court in such proceeding, in exchange solely for stock or securities in such other corporation.

* * * * *

(g) [As amended by Sec. 121 (d) (4), Revenue Act of 1943, *supra*] *Definition of Reorganization*—As used in this section (other than subsection (b) (10) and subsection (l)) and in section 113 (other than subsection (a) (22))—

(1) [As amended by Sec. 213 (b), Revenue Act of 1939, c. 247, 53 Stat. 862] the term "reorganization" means (A) a statutory merger or consolidation, * * * or (D) a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor or its shareholders or both are in control of the corporation to which the assets are transferred, or (E) a recapitalization, or (F) a mere change in identity, form, or place of organization, however effected.

* * * * *

(26 U. S. C. 1952 ed., Sec. 112.)

SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

(a) *Basis (Unadjusted) of Property.*—The basis of property shall be the cost of such property; except that—

* * * * *

(22) [As added by Sec. 121 (c), Revenue Act of 1943, *supra*] *Property Acquired on Reorganization of Certain Corporations.*—If the property was acquired by a corporation upon a transfer to which section 112 (b) (10), or so much of section 112 (d) or (e) as relates to section 112 (b) (10), is applicable, then, notwithstanding the provisions of section 270 of the National Bankruptcy Act, as amended, the basis in the hands of the acquiring corporation shall be the same as it would be in the hands of

the corporation whose property was so acquired, increased in the amount of gain recognized to the corporation whose property was so acquired under the law applicable to the year in which the acquisition occurred, and such basis shall not be adjusted under subsection (b) (3) by reason of a discharge of indebtedness pursuant to the plan of reorganization under which such transfer was made.

* * * * *

(26 U. S. C. 1952 ed., Sec. 113.)

SEC. 718 [As added by Sec. 201, Second Revenue Act of 1940, c. 757, 54 Stat. 974]. EQUITY INVESTED CAPITAL.

(a) *Definition.*—The equity invested capital for any day of any taxable year shall be determined as of the beginning of such day and shall be the sum of the following amounts, reduced as provided in subsection (b)—

(1) *Money Paid In.*—Money previously paid in for stock, or as paid-in surplus, or as a contribution to capital;

(2) [As amended by Sec. 218, Revenue Act of 1942, c. 619, 56 Stat. 798] *Property Paid-in.*—Property (other than money) previously paid in (regardless of the time paid in) for stock, or as paid-in surplus, or as a contribution to capital. Such property shall be included in an amount equal to its basis (unadjusted) for determining loss upon sale or exchange. If the property was disposed of before such taxable year, such basis shall be determined under the law applicable to the year of disposition, but without regard to the value of the property as of March 1, 1913. If the property was disposed of before March 1, 1913, its basis shall be considered to be its fair mar-

ket value at the time paid in. If the unadjusted basis of the property is a substituted basis, such basis shall be adjusted, with respect to the period before the property was paid in, by an amount equal to the adjustments proper under section 115 (l) for determining earnings and profits;

* * * * *

(26 U. S. C. 1952 ed., Sec. 718.)

SEC. 760 [As added by Sec. 230 (a), Revenue Act of 1942, *supra*]. EXCHANGES.

(a) *Definitions, Etc.*—For the purposes of this section—

(1) *"Exchange," "Transferor," and "Transferee."*—The term "exchange" means a transaction by which one corporation (hereinafter called "transferee") receives property of another corporation (hereinafter called "transferor") and the basis of the property received, in the hands of the transferee, for the purposes of section 718 (a) is determined by reference to the basis in the hands of the transferor.

(2) *Determination of Basis of Property Received.*—The basis, in the hands of the transferee, of the property of the transferor received by the transferee upon the exchange shall be determined in accordance with section 718 (a).

(b) *Rule.*—In the application of section 718 (a) to a transferee upon an exchange in determining the amount paid in for stock of the transferee, or as paid-in surplus or as a contribution to capital of the transferee, in connection with such exchange, only an amount shall be deemed to have been so paid in equal to the excess of the basis in the hands of the transferee

of the property of the transferor received by the transferee upon the exchange over the sum of—

(1) The amount of any liability of the transferor assumed upon the exchange and of any liability subject to which such property was so received, plus

(2) The amount of any liability of the transferee (not arising out of any liability described in paragraph (1)) constituting consideration for the property so received, plus

(3) The aggregate of the amount of any money and the fair market value of any other property (other than such stock and other than property described in paragraphs (1) and (2)) transferred to the transferor.

* * * * *

(26 U. S. C. 1952 ed., Sec. 760.)

Revenue Act of 1943, c. 63, 58 Stat. 21:

SEC. 121. REORGANIZATION OF CERTAIN INSOLVENT CORPORATIONS.

* * * * *

(e) *Effective Date.*—Provisions having the effect of the amendments made by subsection (a), subsection (c) (3), and subsection (d) (2), (3), (4), (5), and (6), shall be deemed to be included in the revenue laws respectively applicable to taxable years beginning after December 31, 1933, but shall not affect any tax liability for any taxable year beginning prior to January 1, 1943. * * *

Treasury Regulations 111, promulgated under the Internal Revenue Code of 1939:

SEC. 29.112 (b) (10)–1 [As added by T. D. 5402, 1944 Cum. Bull. 229.] *Trans-*

fer of Property of Insolvent Corporation in Reorganization in Bankruptcy or Receivership Proceeding. — (a) *Exchange solely for stock or securities.*—Section 112 (b) (10) provides for the nonrecognition of gain or loss upon certain exchanges made in connection with the reorganization of an insolvent corporation, hereinafter referred to in these regulations as a "section 112 (b) (10) reorganization." The section does not apply with respect to a railroad corporation as defined in section 77m of the National Bankruptcy Act, as amended. In order to qualify as a section 112 (b) (10) reorganization, the transaction must satisfy the express statutory requirements as well as the underlying assumptions and purposes for which the exchange is excepted from the general rule requiring the recognition of gain or loss upon the exchange of property.

* * * * *

The application of section 112 (b) (10) is to be strictly limited to a transaction of the character set forth in such section. Hence, the section is inapplicable unless there is a bona fide plan of reorganization approved by the court having jurisdiction of the proceeding and the transfer of the property of the insolvent corporation is made pursuant to such plan. It is unnecessary that the transfer be a direct transfer from the insolvent corporation; it is sufficient if the transfer is an integral step in the consummation of the reorganization plan approved by the court. By its terms, the section has no application to a reorganization consummated by adjustment of the capital or debt structure of the insolvent corporation without the transfer of its assets to another corporation.

As used in section 112 (b) (10), the term "reorganization" is not controlled by the definition of "reorganization" contained in section 112 (g). However, certain basic requirements, implicit in the statute, which are essential to a reorganization under section 112 (g), are likewise essential to qualify a transaction as a reorganization under section 112 (b) (10). Among these requirements are a continuity of the business enterprise under the modified corporate form and a continuity of interest therein on the part of those persons who were the owners of the enterprise prior to the reorganization. Thus, the nonrecognition accorded by section 112 (b) (10) applies only to a genuine reorganization as distinguished from a liquidation and sale of property to either new or old interests supplying new capital and discharging the obligations of the old corporation. For the purpose of determining whether the requisite continuity of interests exists, the interest of creditors who have, by appropriate legal steps, obtained effective command of the property of an insolvent corporation is considered as the equivalent of a proprietary interest. But the mere possibility of a proprietary interest is not its equivalent. The determinative and controlling factors are the corporation's insolvency and the effective command by the creditors over its property. The term "insolvent" as used herein refers to insolvency at any time during the course of the proceeding referred to in section 112 (b) (10), either in the sense of excess of liabilities over assets or in the sense of inability to meet obligations as they mature.

* * * * *

U. S. GOVERNMENT PRINTING OFFICE: 1956